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5 Essential Questions Boards Should Ask During the Strategic Planning Season

By Adam Mustafa

As the fall approaches, football is not the only thing we should be anticipating. It's also the start of the strategic planning season. We are now nearly six years past the financial crisis, and the industry has changed dramatically. More changes are coming as Basel III arrives next year for community banks, the artificial interest rate environment eventually returns to normal, and the inevitable consolidation in the industry accelerates. As banks prepare for 2015 and beyond, their thought process for strategic planning must adapt to this new environment. Below are five key questions that every board room in the country should be asking:

1. Acquire, Be Acquired, or Stay the Course?

As M&A activity within the industry increases, how is your bank positioned? If you view your bank as an acquirer, have you already invested in the capacity for smart acquisitions? Many banks would like to make their first acquisition, but are afraid of making a mistake. That is a good instinct as there has already been buyer's remorse on some recent deals. But how do you bridge that gap? Invictus provides its bank M&A clients with groundbreaking forward-looking analytics on targets so they can avoid buying a bill of goods. It is critical to understand the difference between having a strategic, proactive, and patient approach to M&A versus a reactive strategy where you only react to banks that are for sale. The smartest banks with acquisitive capabilities understand that the heavy-lifting is done PRIOR to a target being up for sale, sometimes even years in advance.

If you are planning on staying the course, can your bank generate sufficient returns to your shareholders over the long-term by relying solely on organic growth? The reality is that most banks in the industry are not generating a high enough return. These stay-the-course banks should be comfortable that the organic growth prospects in their market, coupled with untapped operating leverage in their business model, are enough to move the needle.

If you are a seller, when is the right time and what is the right process to maximize shareholder value? Many banks that view themselves as sellers are waiting for multiples to increase. While multiples have increased recently, it is often fool's gold. Many of those transactions are simply strong banks that decided to cash out early. Since the investment banker's job is to find the so-called greater fool, there are many transactions that have been overpriced. Waiting for multiples to increase is a dangerous game.

The OCC's Guidance

"Capital planning is a dynamic and ongoing process that should be forward looking and incorporate changes in your bank's strategic focus, risk tolerance levels, business plans, operating environment, and other factors that materially affect capital adequacy. This is why capital planning becomes an integral part of a bank's strategic planning process."

Source: **A Common Sense Approach to Community Banking**

2. Are we as prepared for a rising interest rate environment as we think?

Many banks are falling into the trap of believing that they are well-positioned for a rising rate environment because their ALM models tell them so. Most ALM models have not yet adapted to the fact that we have been in an unprecedented and artificial interest rate environment for the last six years. Most of the loans on a bank's books now consist of loans made during this period. These loans are typically strong from an asset quality perspective, but have extraordinarily low interest rates (sub 4% in many cases), longer terms, and primarily a fixed-rate structure. Most ALM models have failed to adapt their prepayment speeds to near zero for these loans. Many ALM models I've seen assume that there will be enough new loans originated at higher rates in the future to actually lead to an increase in earnings in a rising rate environment. This is very dangerous and puts too much trust in the Federal Reserve's ability to tie rising rates to increasing economic activity. Did you know the Fed tested a mini-stagflation scenario with the top 30 BHCs in CCAR in the Adverse Case scenario?

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Meanwhile, surge deposits, most of them non-interest bearing, could become more expensive CDs or leave the bank altogether. The investment portfolio may become virtually illiquid if the market value falls below its book value.

Banks should be determining how they want to position themselves for a rising rate environment in their strategic planning process. The ALCO process should then manage the execution of this plan, not the other way around. Don't let the tail wag the dog.

3. How much capital do we need?

As Basel III arrives, remember one thing: Basel III only establishes the minimum levels of capital acceptable to regulators. Regulators typically want banks to maintain levels of capital well above those minimums. The question then becomes, how much capital does my bank need?

At Invictus, we help banks customize their own capital requirements by using CCAR-style stress testing. Every bank is unique. A one-size fits all approach to capital requirements doesn't make sense.

It is critical to find the right balance of capital. Capital is the most expensive source of funding. If you have too much capital, it will be more difficult to generate a sufficient return on that capital. If you have too little capital, you will be constrained.

One tip for strategic planning – determine what you want your assets to look like in the next 3-5 years, and then design the right hand side of your balance sheet to fit that. Your capital plan should be built around your strategic plan. Too many banks do the reverse of this.

4. How much return do we need on that capital?

At its core, a strategic plan consists of a series of actions that are designed to get you from where you are today to where you want to be. Examples include loan growth, acquisitions, starting or growing new business lines or products, buying or selling branches, and certainly dividends and stock buybacks. Each of these actions should be evaluated from a risk/return perspective relative to other viable alternative uses of that capital. The smartest banks are figuring out where they get the best bang for the buck as they deploy their capital. That's why they generate the best returns in the industry, irrespective of their size.

5. How are we competitively positioned in our markets?

Planning should not be done in a vacuum. For example, if you can see that some of your competitors will have capital issues, you can take advantage of that weakness. Many banks are projecting loan growth with blinders on. If you want to grow your CRE by 15 percent next year, are you growing with the pie, or are you increasing your share of the pie? This will serve as both a reality check to your assumptions, and also guide your execution of the strategy. ▪

What Your Strategic Plan Should Answer

The OCC says that each bank's strategic planning process should answer these questions:

1. Where are we now?
2. Where do we want to be?
3. How do we get there?
4. How do we measure our progress?

About the Expert

Adam Mustafa is a co-founder of Invictus Consulting Group and has been providing stress testing and capital adequacy advisory services to banks, regulators, bank investors, and bank D&O insurers since the beginning of the financial crisis. Mr. Mustafa has overseen the design and implementation of fully-customized capital stress testing, capital management, and strategic planning systems for community banks ranging from under $100M in assets to Dodd-Frank banks that have in excess of $10B in assets. Within the community banking space, he has advised acquisitive and high growth banks, banks under enforcement action and significant regulatory pressures, and de novo banks. He has also been a featured speaker on stress testing for community banks at a number of conferences, including those hosted by regulators. Prior to joining Invictus, he had senior-level experience as a banker, financial services consultant and corporate CFO. He has an MBA from Georgetown University and a BA from Syracuse University.

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Ex-FDIC Official, Banker Discuss Exam Priorities, Stress Testing, M&A

Thomas Dujenski retired as the FDIC Regional Director in Atlanta in May, after a 31-year career at the agency. He now works as a managing director for Alvarez & Marsal, a consulting firm. Bank Insights posed questions to Dujenksi and Bruce Stevenson, a former senior vice president of HSBC North America Holdings, who also recently joined A&M. This is a condensed version of the conversation.

Q: What are the supervisory priorities for the FDIC? The OCC indicated in its latest risk perspective that it is focusing on strategic and capital planning and interest rate risk. Are those priorities for the FDIC as well?

A Dujenski: This is the lowest interest rate environment we've ever been in. Examiners will be focusing attention, in my opinion, on the longer term assets on balance sheets. There will be also a focus on corporate governance, information technology and risk related to cyber threats. Strategic and capital planning will be priorities for all the regulators. Many institutions in the last 4 1/2 years were working through the crisis and are now focusing on strategic plans. They need to ask themselves: Where do they want to be and where do they want to grow in the next three to five years? Banks need to make sure when they are developing their strategic plans that they have a good understanding of the risk profile that the institution wants to have.

Stress testing and strategic planning are linked. What we are seeing is that a bank that has a good stress testing program in place will be able to make sure it has adequate capital to withstand any of the changes in the economy that will impact its strategic plans.

Banks should engage in stress testing based on the level and complexity of the institution. For institutions that fall below the concentration thresholds, look at the interest-rate risk guidance on stress testing and the guidance on concentration of credits.

Stevenson: While there is not a specific mandated program for stress testing, the regulatory expectations are quite clear. If you look at the regulatory guidance, the FDIC and the OCC have come pretty close to saying you have to do this.

Q: What lessons can smaller banks learn from the CCAR stress testing of the largest banks?

A Stevenson: If you have never done capital planning before, be prepared for challenges and difficulties of doing it. Doing risk assessments and capital planning is hard. It takes a change of mindset to do stress testing. Often bankers are somewhat reluctant to anticipate the downside risks emerging with the largest bank customer, or individual counterparties. To the extent that CRE lending is a major driver of earnings, there should be a stress testing program in place to assess the downside risk in that business.

Q: Invictus Consulting Group's whitepaper "Bleeders and Leaders: Redefining the 2014 U.S. M&A Banking Market," concluded that stress testing should be a critical component of any bank's M&A analytics. What do you think?

A Dujenski: When you have a comprehensive stress testing plan in place to look at a merger, it provides invaluable information to management, the board and regulators.

Stevenson: I agree with the overall assessment. It's a very significant opportunity for the best banks to differentiate themselves. One of the most valuable tools is the ability to do loss forecasting on not only the acquiring bank but also on the combined entity.

That can lead to an accurate assessment of losses on acquired portfolios. It's a clear competitive advantage for banks that are seeking to grow through acquisitions.

The largest of the smallest banks are very much at a place where they do need to do a very thorough job of stress testing, for their own purposes, and for the acquisition to be approved by the regulators.

Q: What can community banks do to improve their CAMELS scores?

A Dujenski: The best thing an institution can do is to make sure they have a good strategic plan in place, good policies and procedures, robust plans for BSA compliance, good underwriting criteria and that they are preparing for capital planning and for stress testing. They need to be approaching risk from an enterprise-wide basis. If it's a new area of risk, the bank must engage all areas in an integrated basis rather than a silo approach. To have a good exam, make sure you have good capital planning, good assets, a plan for sufficient liquidity and a board of directors that is engaged in all activities of the bank. You must also have the type of information systems that are necessary to make sure that management is following the bank's policies.

Stevenson: My sense is that community banks that focus on enterprise risk assessment and the ability to do scenario analysis on an enterprise-wide basis will significantly improve their M and C portions as well. ▪

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

Strong Banks Hit with Matters Requiring Board Attention

Examiners handed out MRBAs to about 48 percent of banks with satisfactory CAMELS ratings from 2010 to 2013, and 85 percent of those banks were rated a 1 or 2, the FDIC reveals in its **latest issue** of *Supervisory Insights*. Loan issues (such as problem assets, ALLL and concentrations) accounted for 69 percent of the warnings, while lax board or management policies, (including audits, policies and inadequate strategic planning) made up 45 percent. Interest rate risk, which was cited in 17 percent of the MRBAs in 2010, skyrocketed to 30 percent in 2013. The good news: About 80 percent of the time the bank was able to address the deficiencies in its first response to the FDIC.

Regulators Reject Big Banks' Living Wills

The Federal Reserve board of governors and the FDIC board roundly **rejected** the latest round of so-called living wills from the nation's largest banks, deeming them not credible. FDIC Vice Chairman Thomas Hoenig said in a **statement** that the material presented by the banks provided no clear path to resolution that wouldn't require public support. He said the banks "are generally larger, more complicated, and more interconnected than they were prior to the crisis of 2008," and pointed out their balance sheets had only been "marginally" strengthened. The ICBA applauded Hoenig's remarks, pointing out that community banks would suffer if the too-big-to-fail banks require government intervention.

Read Volcker Rule, Just in Case

The OCC has developed **"interim exam procedures"** to help examiners enforce the Volcker Rule by July 21, 2015. Community banks that don't engage in trading or investment covered by the rule don't need to worry about it -- but the only way to know that is to read the rule to find out if your bank is indeed exempt. The law firm of Nelson Mullins advises every national bank to "review its status under the rule, even if it believes it does not engage in Volcker-covered activities." The law firm expects Fed and FDIC examiners to use similar standards.

HMDA Rule Changes Top 570 Pages

The CFPB's 573-page **proposed rule** changing the Home Mortgage Disclosure Act expands data reporting requirements, adding new categories on property value, loan terms, points, fees and creditor information. The rule would also require banks to provide more information about underwriting and pricing, such as an applicant's debt-to-income ratio, the interest rate of the loan, and the total discount points charged for the loan. Small banks with a low loan volume—fewer than 25 mortgages a year—would not have to report HMDA data.

Should Call Reports Be Simplified?

Here's a new one: The ICBA wants bank regulators to institute a "short-form" **Call Report** for well-capitalized community banks for two quarters a year. The advocacy group says that 72 percent of recent respondents to a survey said they would support such a move.

Fed Says Some Municipal Lending is Risky

Community banks need to have "effective risk management programs in place" to cover municipal lending, the Federal Reserve warns in the **latest issue** of *Community Banking Connections*. The article, written by examiners at the Federal Reserve Bank of Philadelphia, says the view that municipal lending is a low-risk lending activity "may be debatable." Community banks have reported an increase in municipal loans of nearly 25 percent over the past two years, and community banks with assets between $1 billion and $10 billion reported an increase of 157 percent since 2007, the article notes. ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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